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No. 95-325

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

REORGANIZED CF&I FABRICATORS OF UTAH, INC., COLORADO & UTAH LAND COMPANY, KANSAS METALS COMPANY, ALBUQUERQUE METALS COMPANY, REORGANIZED PUEBLO METALS COMPANY, DENVER METALS COMPANY, REORGANIZED PUEBLO RAILROAD SERVICE COMPANY, REORGANIZED CF&I FABRICATORS OF COLORADO, INC., REORGANIZED CF&I STEEL COPORATION, AND REORGANIZED COLORADO AND WYOMING RAILWAY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTIONS PRESENTED

1. Whether the claim of the United States against the debtor in bankruptcy for an excise tax owed under Section 4971(a) of the Internal Revenue Code, 26 U.S.C. 4971(a), is entitled to the distributive priority for an "excise tax" accorded under Section 507(a)(7)(E) of the Bankruptcy Code, 11 U.S.C. 507(a)(7)(E).[1]

2. Whether, in the absence of inequitable conduct by the government in obtaining or enforcing its claim, the excise tax claim of the United States under Section 4971(a) of the Internal Revenue Code may be subordinated to general unsecured claims under the "principles of equitable subordination" codified in Section 510(c) of the Bankruptcy Code, 11 U.S.C. 510(c).[2]

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[1] Section 304(c) of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4132, added a new seventh priority for alimony and child support claims and changed the preexisting priority for excise taxes from seventh to eighth. Those amendments have no significance for the issues presented in this case.

[2] This case will be argued in tandem with *United States* v. *Noland*, No. 95-323, which presents a closely analogous question concerning the proper scope of the "principles of equitable subordination" in bankruptcy cases. We have furnished a copy of the brief for the United States in *United States* v. *Noland* to counsel for respondents in this case. We have also furnished a copy of the brief for the United States in this case to counsel for respondent in *United States* v. *Noland*.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a) is reported at 53 F.3d 1155. The opinion of the district court (Pet. App. 10a-11a) is unreported. The opinion of the bankruptcy court (Pet. App. 38a-62a) is reported at 148 B.R. 332.

JURISDICTION

The judgment of the court of appeals was filed on April 27, 1995. On July 14, 1995, Justice Breyer extended the time for filing a petition for a writ of cer-

tiorari to and including August 25, 1995. The petition was filed on August 24, 1995, and was granted on December 1, 1995. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of Section 507(a)(7) and 510(c) of the Bankruptcy Code, 11 U.S.C. 507(a)(7) and 510(c) (1988), and of Section 4971 of the Internal Revenue Code, 26 U.S.C. 4971, are set forth at Pet. App. 63a-66a.

STATEMENT

1. Respondents are the Reorganized CF&I Steel Corporation and its nine subsidiaries. Prior to 1990, these corporations maintained defined-benefit pension plans for their employees that were subject to the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1001 *et seq.* For the year that ended on December 31, 1989, respondents failed to make required pension plan contributions of $12,400,000. The plans therefore had an "accumulated funding deficiency" equal to that amount. See 26 U.S.C. 412(a). In November 1990, respondents filed petitions for reorganization under Chapter 11 of the Bankruptcy Code (Pet. App. 2a).

Subtitle D of the Internal Revenue Code is entitled "Miscellaneous Excise Taxes." One of the provisions of that subtitle—Section 4971(a) of the Internal Revenue Code—imposes a 10% excise tax on the amount of any "accumulated funding deficiency" of qualified pension plans. 26 U.S.C. 4971(a). The excise tax liability for respondents' "accumulated funding deficiency" under Section 4971(a) was therefore approximately $1,240,000. The Internal Revenue

Service filed proofs of claims for that amount in respondents' bankruptcy case (Pet. App. 2a-3a).[3]

The government's proofs of claims assert that the liability for this excise tax under Section 4971(a) of the Internal Revenue Code is entitled to seventh priority in the distribution of the assets of the debtors' estates under Section 507(a)(7)(E) of the Bankruptcy Code.[4] As applicable to this case, Section 507(a)(7)(E)

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[3] The proofs of claims filed by the United States also asserted (i) priority claims for excise taxes under Section 4971(a) for the subsequent plan year, (ii) priority claims for excise taxes under Section 4971(b) for both the 1989 and 1990 plan years, (iii) nonpriority claims for penalties related to the Section 4971(a) excise tax for 1980 and (iv) priority claims for income taxes for various years. Section 4971(b) of the Internal Revenue Code imposes an additional excise tax, equal to 100 percent of the "accumulated funding deficiency," on employers who fail to correct the deficiency within a specified period. 26 U.S.C. 4971(b). The government did not appeal the adverse rulings relating to any of those claims.

[4] The Pension Benefit Guaranty Corporation (PBGC) also filed proofs of claims in this case. The PBGC is a corporation owned by the United States that guarantees payment of certain vested benefits under terminated pension plans. See 29 U.S.C. 1301 *et seq.* The PBGC obtains funds for that purpose from insurance premiums paid by the employers whose pension plans are subject to Title IV of ERISA. See 29 U.S.C. 1306-1307 (1988 & Supp. V 1993). In March 1992, when one of the debtors' pension plans was terminated, the PBGC became the statutory trustee for the plan pursuant to 29 U.S.C. 1342. The PBGC thereby became liable to plan participants for guaranteed benefits.

The PBGC filed proofs of claims in the bankruptcy case seeking to recover unpaid pension plan contributions. The PBGC also sought to recover its own statutory claim for unfunded benefits. See 29 U.S.C. 1362(a) and (b). The PBGC asserted various priorities for its claims, including administrative tax priority under Sections 503(b)(1)(B) and 507(a)(1) of the

provides a "[s]eventh" priority for governmental claims for any "excise tax" that arose during the three years immediately preceding the date of the filing of the bankruptcy petition. See 11 U.S.C. 507(a)(7)(E)(i) and (ii) (1988); note 1, *supra*. Section 507(a)(7)(G) of the Bankruptcy Code provides the same "[s]eventh" priority to a statutory penalty that is "related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss." 11 U.S.C. 507(a)(7)(G) (1988).

Respondents filed an objection to the government's claim. They argued that the excise tax claims under Section 4971(a) were neither a "tax" nor a penalty compensating for pecuniary loss and should therefore be denied any priority under Section 507 of the Bankruptcy Code.

2. The bankruptcy court allowed the government's claim under Section 4971(a) of the Internal Revenue Code but denied that claim any priority under Section 507(a)(7)(E) of the Bankruptcy Code. The court recognized (Pet. App. 47a-48a) that, in *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (1991), cert. denied, 502 U.S. 1092 (1992), the Sixth Circuit held that the excise tax imposed by Section 4971(a) must be given priority in bankruptcy. In *Mansfield Tire*, the court reasoned that, since Congress denominated Section 4971 as an excise tax and further expressly provided that claims for excise taxes have priority in bankruptcy under Section 507(a)(7)(E), the plain language of the statutes must be followed without regard to the underlying "purpose" served by the tax. 942 F.2d at 1059. The bankruptcy court, however, rejected the Sixth Circuit's ruling as "unnecessarily rigid" (Pet. App. 48a). The court stated that the fact that Congress denominated the tax imposed by Section 4971 as an excise tax should be disregarded in applying the Section 507(a)(7)(E) priority provision, for "blind acceptance of the label would defeat the purpose of the Bankruptcy Code" (Pet. App. 49a).

The court concluded that allowing a priority for the excise tax imposed under Section 4971(a) would be anomalous for several reasons. First, the court expressed concern that priority treatment of the excise tax claim would elevate that claim above the PBGC's claims for the underlying funding deficiency (Pet. App. 51a; see note 4, *supra*). Second, the court stated that, because bankruptcy courts may independently review state and local exactions to determine whether they represent a priority "tax" or a non-priority penalty, a failure similarly to review federal exactions would result in a "disparate treatment" that "the Bankruptcy Code does not contemplate" (Pet. App. 51a). Third, the court stated that payment of priority excise tax claims would burden respondents' efforts to reorganize, would diminish the return of other creditors and would give a "windfall" to the government (*ibid.*). Fourth, because the priority excise tax claims would be paid before the claims of the pensioners themselves, the court stated that the excise tax priority would harm the very parties that Section 4971 was intended to protect (Pet. App. 51a). For these reasons, the court concluded that it must be "empowered, under the circumstances of this case,

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Bankruptcy Code, 11 U.S.C. 503(b)(1)(B), 507(a)(1). The bankruptcy court concluded that most of the PBGC's claims were unsecured and had no priority in distribution of assets of the estates. The district court upheld those rulings but remanded on another issue; its order is therefore not yet final. See *PBGC v. Reorganized CF&I Fabricators of Utah, Inc.*, 179 B.R. 704 (D. Utah 1994).

to look behind the characterization of the exaction set forth in the statute and focus on the actual nature of the claims" (Pet. App. 52a).

The bankruptcy court applied what it termed the *Lorber Industries* "test" to determine the "actual nature" of the tax (Pet. App. 52a). That test derives from *County Sanitation District No. 2* v. *Lorber Industries of California, Inc.*, 675 F.2d 1062 (9th Cir. 1982), which was a bankruptcy case involving collection of a county sewer use fee. The Ninth Circuit held in that case that the following four elements characterize a "tax," as distinguished from a user fee, for purposes of determining entitlement to priority under the former Bankruptcy Act:

(a) An involuntary pecuniary burden, regardless of name, laid upon individuals or property;
(b) Imposed by, or under authority of the legislature;
(c) For public purposes, including the purposes of defraying expenses of government or undertakings authorized by it;
(d) Under the police or taxing power of the state.

675 F.2d at 1066. In the present case, the bankruptcy court concluded, under "its own independent application" of the *Lorber* standard, that the excise tax imposed under Section 4971(a) is not a "tax" but is in the nature of a penalty and is therefore not entitled to priority under Section 507(a)(7) of the Bankruptcy Code (Pet. App. 52a).

3. The United States appealed to the district court. While that appeal was pending, respondents issued a proposed plan of reorganization. The United States objected to the proposed plan because it failed

to make provision for payment of the Section 4971(a) excise tax in the event that the United States prevailed on its appeal of the priority issue. The bankruptcy court nonetheless confirmed the plan. The United States appealed from the order of confirmation.

In the meantime, respondents initiated an adversary proceeding in their bankruptcy case, seeking to subordinate the Section 4971(a) excise tax claims to the claims of general unsecured creditors. Respondents relied on Section 510(c) of the Bankruptcy Code, which authorizes bankruptcy courts to apply "principles of equitable subordination [to] subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." 11 U.S.C. 510(c). Respondents contended that "principles of equitable subordination" permit the court to subordinate claims for "penalties" even if the holder of the claim has not engaged in any inequitable conduct. The bankruptcy court agreed with respondents and ordered the Section 4971(a) excise tax claim to be "subordinated to the claims of all other general unsecured creditors of the Debtors pursuant to 11 U.S.C. § 510(c)" (Pet. App. 21a). The United States appealed that order.

4. a. Twelve days after the bankruptcy court issued its original order denying priority to the Section 4971(a) tax, the Tenth Circuit issued its decision in *United States* v. *Dumler*, 983 F.2d 161 (1992). That case involved the bankruptcy priority of the government's claim for the 10 % "additional tax" imposed under Section 72(t) of the Internal Revenue Code upon early distributions from qualified retirement plans. The question in *Dumler* was whether that "additional tax" (26 U.S.C. 72(t)) is a "tax on or

measured by income" that is entitled to seventh priority in bankruptcy under 11 U.S.C. 507(a)(7)(A) (1988). The Tenth Circuit held in *Dumler* that, although Section 72(t) purports to impose a "tax," it in fact imposes a "penalty" for a nonpecuniary loss and therefore has no priority in bankruptcy.[5] 983 F.2d at 164-165. In reaching that conclusion, the Tenth Circuit stated that it rejected the reasoning of the Sixth Circuit in *Mansfield Tire* and held that it could "recharacterize for purposes of bankruptcy what Congress has deemed a tax in the Internal Revenue Code." 983 F.2d at 162, citing *In re Unified Control Systems, Inc.*, 586 F.2d 1036 (5th Cir. 1978).

b. In the present case, the district court consolidated the government's appeals from the orders of the bankruptcy court that (i) denied priority to the Section 4971(a) claim, (ii) confirmed the plan of reorganization, and (iii) subordinated the Section 4971(a) claim to the claims of all general unsecured creditors. The district court affirmed all three orders, reasoning that the Section 4971(a) excise tax "is a nonpecuniary loss penalty, not a tax" (Pet. App. 18a). The court stated that equitable subordination of the government's claim is appropriate "primarily" for the reasons set forth in the Tenth Circuit's opinion in the *Dumler* case (*ibid.*). But see note 5, *supra*.

5. The court of appeals affirmed (Pet. App. 1a-9a). Relying on its previous decision in *Dumler*, the court held that the name that Congress gives an exaction under the Internal Revenue Code does not determine

[5] The question whether the doctrine of equitable subordination would permit subordination of such a claim to all other general unsecured claims was not presented or addressed in *United States* v. *Dumler*.

its status in applying the priority provisions of Section 507(a)(7) of the Bankruptcy Code. The court stated that whether an exaction is a "tax" or a "penalty" for purposes of bankruptcy priority is to be determined by application of the four-part test of *Lorber Industries* (Pet. App. 6a). Under that test, the court concluded that the Section 4971(a) excise tax is in substance a "penalty," rather than a "tax," "for substantially the reasons given by the bankruptcy court" (Pet. App. 6a).

The court then addressed the equitable subordination of the government's claim. The court first noted that, "[b]ecause we have determined that the [claim of the United States in this case] is a nonpecuniary loss penalty not entitled to section 507 priority," the court had no reason to consider whether a claim that is entitled to priority under Section 507 may be subordinated to other claims under the "principles of equitable subordination" (Pet. App. 6a).[6] The court then acknowledged that equitable subordination historically has been imposed only when a creditor has engaged in wrongful conduct and that "the bankruptcy court expressly found that 'there [had] been no inequitable conduct on the part of the Internal Revenue Service'" in this case (Pet. App. 6a, 7a). The court stated, however, that in codifying the "principles of equitable subordination" in Section

[6] Whether a "case-by-case" balancing of the "equities" may be applied to subordinate a claim that the court believes to be "unfair" to other creditors even when Congress has expressly designated such a claim as a priority claim in Section 507 of the Bankruptcy Code—a question that the court of appeals asserted that it was not required to reach in this case—was addressed and answered affirmatively in *United States* v. *Noland*, No. 95-323. See note 2, *supra*.

510(c) of Bankruptcy Code, "Congress intended courts to continue developing" those principles (Pet. App. 7a). The court reasoned that the "developing" principles of equitable subordination permit a court (*id.* at 8a, quoting *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990)):

> to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors.

In particular, the court held that these developing "principles of equitable subordination" do "not require a finding of claimant misconduct to subordinate nonpecuniary loss tax penalty claims" (Pet. App. 8a, citing, *e.g.*, *Burden* v. *United States*, 917 F.2d 115, 116-120 (3d Cir. 1990); *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 231-234 (8th Cir. 1990)).

Turning to "the equities in this case" (Pet. App. 8a), the court held that subordination is appropriate because the PBGC and other "general unsecured creditors of CF&I will receive only a small percentage of their claims" and "[d]eclining to subordinate the [excise tax claim of the United States] would harm innocent creditors rather than punish the debtor for failing to fund the pension plan" (*ibid.*).

INTRODUCTION AND SUMMARY OF ARGUMENT

1. This case presents two related questions concerning the proper application of the statutory priorities that Congress has established for the distribution of the assets of a debtor's estate. The first concerns whether the statutory "[s]eventh" priority for "an excise tax" in Section 507 of the

Bankruptcy Code (11 U.S.C. 507(a)(7)(E) (1988)) is available only when the underlying purpose of the "excise tax" is to raise revenue rather than to penalize or discourage undesirable conduct.

Section 4971(a) of the Internal Revenue Code imposes a 10% excise tax on a taxpayer's failure to meet the minimum funding requirements for its qualified pension plan (26 U.S.C. 4971(a)). The tax imposed by Section 4971(a) was expressly designated as an "excise tax" by Congress and therefore falls literally, and precisely, within the statutory priority for any "excise tax" under Section 507(a)(7)(E) of the Bankruptcy Code.

The text and history of Section 507 both reflect that the priority that Congress granted to excise taxes is not conditioned on a finding that the tax is primarily designed to raise revenues. Excise taxes are routinely enacted by Congress to monitor and discourage particular types of conduct. Congress has not authorized courts to limit the statutory priority for such excise taxes to situations where the tax reimburses the government for some "actual pecuniary loss" (Pet. App. 52a). Excise taxes—like other taxes—are rarely designed to reimburse the government for a "pecuniary loss." If the statutory priority for "excise taxes" were available only when the government has incurred an "actual pecuniary loss," the priority would only rarely apply. Congress did not intend the unqualified, comprehensive priority that it provided for excise taxes in Section 507(a)(7)(E) to be given such an implausibly narrow scope.

2. The court of appeals not only concluded that the excise tax imposed by Section 4971(a) should be denied the statutory "[s]eventh" priority established for excise taxes under Section 507. The court further held

that the government's excise tax claim should be subordinated even to the claims of general unsecured creditors. The court based that holding on the "principles of equitable subordination" codified in Section 510(c) of the Bankruptcy Code, 11 U.S.C. 510(c).

The "principles of equitable subordination" that Congress codified in Section 510(c) authorize courts to subordinate an individual claim upon a showing that the creditor obtained its claim through misconduct or other inequitable behavior. The "principles of equitable subordination" do not permit a court categorically to prefer one type of innocent claimant over another. The categorical arrangement of the priorities afforded to different types of claims is a matter for Congress to decide, and a matter that Congress *has* decided. Equitable subordination operates in a field necessarily left unresolved by Congress—counteracting inequities resulting from the individual misconduct of creditors. That limited scope of the doctrine of equitable subordination was well-established when the "principles of equitable subordination" were codified in Section 510(c). The text of the statute and its legislative history confirm that Section 510(c) does not provide the courts with authority to disregard statutory priorities based upon a judicial conclusion that a *different* categorical priority scheme would result in a fairer or more equitable scheme of distribution.

In cases that arise under Chapter 11 of the Bankruptcy Code—such as the present case—"penalty" claims not involving pecuniary loss are within the same distributive category as general unsecured claims. If, as the court of appeals concluded, the Section 4971 excise tax claim involved in this case is

not entitled to priority under Section 507(a)(7)(E) of the Bankruptcy Code—on the theory that it is a "penalty" claim not involving pecuniary loss—the government's claim is then entitled to treatment on a parity with the general unsecured claims of other innocent creditors in this Chapter 11 case.

ARGUMENT

I

THE CLAIM OF THE UNITED STATES FOR AN EXCISE TAX OWED UNDER SECTION 4971(A) OF THE INTERNAL REVENUE CODE, 26 U.S.C. 4971(A), IS ENTITLED TO THE DISTRIBUTIVE PRIORITY FOR AN "EXCISE TAX" PROVIDED BY SECTION 507(A)(7)(E) OF THE BANKRUPTCY CODE, 11 U.S.C. 507(A)(7)(E) (1988)

Before entering bankruptcy, respondents incurred liability to the United States for an excise tax imposed under Section 4971(a) of the Internal Revenue Code, 26 U.S.C. 4971(a). Under Section 507(a)(7)(E) of the Bankruptcy Code, claims for excise taxes for which a return was due within three years of the petition for relief are granted "[s]eventh" priority in the distribution of the bankruptcy estate. See 11 U.S.C. 507(a)(7)(E)(i) (1988). See note 1, *supra*. The courts below denied priority to the government's excise tax claim in this case, however, on the ground that the excise tax under Section 4971(a) is intended to penalize the debtor rather than to raise revenue or compensate the government for "actual pecuniary loss" (Pet. App. 6a, 52a).

1. The court of appeals erred in holding that the excise tax imposed by Section 4971(a) is not entitled to the priority that Congress expressly provided to

every "excise tax" under Section 507(a)(7)(E) of the Bankruptcy Code. Congress enacted Section 4971 of the Internal Revenue Code as part of the Employee Retirement Income Security Act of 1974 (ERISA). In connection with the qualified pension plan arrangements authorized by ERISA, Section 4971 was enacted to "impose[] an *excise tax* on the employer if he fails to fund the plan at the minimum required amounts." H.R. Rep. No. 807, 93d Cong., 2d Sess. 97 (1974) (emphasis added). Even before the Bankruptcy Code was enacted in 1978, Congress expressly designated the tax imposed by Section 4971 as an "excise tax" (*ibid.*; see also S. Rep. No. 383, 93d Cong., 1st Sess. 24, 33, 70 (1973)). Section 4971 was placed within Subtitle D of the Internal Revenue Code—which is entitled "Miscellaneous Excise Taxes"—precisely because Congress understood and intended that Section 4971 *is* an "excise tax" (H.R. Rep. No. 807, *supra*, at 97).[7]

When the Bankruptcy Code was enacted in 1978, one of the changes that it made to the provisions of the former Bankruptcy Act was the new, express specification of a "[s]eventh" priority for "excise tax" claims. Compare 11 U.S.C. 507(a)(7)(E) (1988) with 11

[7] Like other taxes—and unlike penalties—the Section 4971 excise tax is required to be reported on, and paid with, a return (IRS Form 5330). 26 C.F.R. 54.6011-1(a). The return for the tax at issue in the present case was due "after three years before the date of the filing of the petition [for relief in bankruptcy]" (11 U.S.C. 507(a)(7)(E)) and therefore comes directly within the terms of the excise tax priority in Section 507(a)(7)(E). See Pet. App. 41a (the "payment should have accompanied [respondent's] form 5330 annual report that the parties agree was due on September 15, 1990").

U.S.C. 104(a) (1976).[8] The joint floor statements that accompanied enactment of the Bankruptcy Code described the intended scope of this specific "excise tax" priority:

> All Federal, State, or local taxes *generally considered or expressly treated as excises* are covered by this category, including sales taxes, estate and gift taxes, gasoline and special fuel taxes, and wagering and truck taxes.

124 Cong. Rec. 32,416 (1978) (Rep. Edwards) (emphasis added); *id.* at 33,998, 34,016 (Sen. DeConcini) (same).[9]

Because Congress "expressly treated" the excise tax created under Section 4971 of the Internal Rev-

[8] Section 64a of the former Bankruptcy Act granted fourth priority to "taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy." 11 U.S.C. 104(a) (1976). In turn, Section 17a of the former Act provided that a discharge in bankruptcy would not release the bankrupt of liability for taxes that became due and owing within three years before bankruptcy, certain assessed and unassessed taxes for which the bankrupt failed to make a return, taxes the bankrupt attempted to evade or defeat or with respect to which the bankrupt made a fraudulent return, and taxes the bankrupt collected or withheld from others but failed to pay over. 11 U.S.C. 35(a) (1976).

[9] The House and Senate did not hold a formal conference in connection with the final enactment of the Bankruptcy Code (Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549, commonly known as the Bankruptcy Reform Act of 1978). The floor statements of the sponsors served in place of a conference committee report (see F. Kennedy, *Foreword: A Brief History of the Bankruptcy Reform Act*, 58 N.C.L. Rev. 667, 676-677 (1980)) and have been regarded as persuasive evidence of congressional intent. *Begier* v. *IRS*, 496 U.S. 53, 64 n.5. (1990).

enue Code as an "excise tax" even before the Bankruptcy Code was enacted, the Sixth Circuit correctly concluded in *United States* v. *Mansfield Tire & Rubber Co.*, 942 F.2d at 1059, that this tax is entitled to the "[s]eventh" priority established by Section 507(a)(7)(E). As this Court stated in *United States* v. *Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989), when the language of the Bankruptcy Code is plain, "the sole function of the courts is to enforce it according to its terms." *Id.* at 241, quoting *Caminetti* v. *United States*, 242 U.S. 470, 485 (1917). Moreover, as we have shown, while resort to the legislative history of these provisions is therefore unnecessary, that history leaves no room for any different conclusion.

2. The court of appeals erred in concluding (Pet. App. 5a) that an "excise tax" that exacts a "penalty" is not an "excise tax" within the meaning of Section 507(a)(7)(E) of the Bankruptcy Code. As the Sixth Circuit explained in *United States* v. *Mansfield Tire & Rubber Co.*, 942 F.2d at 1059, Congress expressly granted priority to any "excise tax" without adding any limitation based upon the "purpose" of the tax. Moreover, Congress clearly understood that an excise tax is no less an "excise tax" because it has a regulatory or deterrent purpose. Excise taxes in the Internal Revenue Code are often imposed on disfavored activities and are often designed to discourage or punish undesirable conduct. See, *e.g.*, 26 U.S.C. 4064 (gas guzzler tax), 4681 (Supp. V 1993) (tax on ozone-depleting chemicals), 4701 (tax on "registration-required" obligations not issued in registered form), 4911 (tax on excess lobbying by public charities), 4941 *et seq.* (tax on undistributed income and speculative investments of private foundations), 4955 (tax on political expenditures by Section

501(c)(3) organizations), 4981 and 4982 (taxes on undistributed income of real estate investment trusts and regulated investment companies), 4999 (tax on "golden parachute" payments), 5881 (tax on "greenmail"). If Congress had intended to exclude so many federal excise taxes from the excise tax priority, one would expect to find some indication to that effect in the Bankruptcy Code or in its legislative history. Instead, the legislative history specifies that the priority for excise taxes comprehensively includes "[a]ll [f]ederal, [s]tate or local taxes generally considered or expressly treated as excises" (124 Cong. Rec. 32,416 (1978) (Rep. Edwards) (listing the excise tax on "wagering" as one example)).

Related provisions of the Bankruptcy Code evidence that Congress intentionally omitted any distinction among excise taxes in enacting the priority for such taxes in Section 507(a)(7)(E). In Section 507(a)(7)(G), separate and apart from the "excise tax" priority of Section 507(a)(7)(E), Congress established an additional "[s]eventh" priority for tax-related "penalt[ies]" that are "in compensation for actual pecuniary loss" (11 U.S.C. 507(a)(7)(G)).[10] This Court

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[10] The courts below correctly noted (Pet. App. 4a, 52a) that a "penalty" that does not represent compensation for "pecuniary loss" does not fall within the priority for penalties that are "in compensation for actual pecuniary loss" under Section 507(a)(7)(G) of the Bankruptcy Code, 11 U.S.C. 507(a)(7)(G). The courts below erred, however, in reasoning (Pet. App. 5a, 52a) that, if the Section 4971(a) excise tax represents a "penalty" that does not compensate for pecuniary loss, it is *therefore* not entitled to priority under the Code. The fact that an excise tax might not qualify for one priority—under Section 507(a)(7)(G)—has no logical or appropriate bearing on whether

has noted that "it is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another" (*City of Chicago* v. *Environmental Defense Fund*, 114 S. Ct. 1588, 1593 (1994), quoted in *BFP* v. *Resolution Trust Corp.*, 114 S. Ct. 1757, 1761 (1994)). That presumption is especially appropriate when, as here, language conditioning an express priority is used in one paragraph and omitted in another paragraph of the same subsection of the statute. Thus, if Congress had intended to exclude from the priority that it established for "excise taxes" any excise tax that might be "punitive" rather than "compensatory" in nature, it surely knew how to do so—it had to look no further than Section 507(a)(7)(G) to find a model. Instead, Congress deliberately chose to include all of the numerous "excise taxes" that it has enacted over the years within the same "[s]eventh" priority, which encompasses all those taxes "generally considered or expressly treated as excises" (124 Cong. Rec. 32,416 (1978)). See also note 10, *supra*. That legislative determination of the priority to be afforded to "excise tax" claims in bankruptcy is, of course, binding on the courts. *United States* v. *Embassy Restaurant*, 359 U.S. 29, 31-32 (1959); *Nathanson* v. *Labor Board*, 344

such an excise tax is separately entitled to the *different* priority established by Congress for "excise taxes" in Section 507(a)(7)(E). Indeed, if an excise tax had to qualify for priority as a "penalty" compensating for "pecuniary loss" (under Section 507(a)(7)(G)), Congress would not have found it necessary to specify that "excise taxes" are entitled to priority under Section 507(a)(7)(E). In short, Congress specified that excise taxes need qualify for priority only under *one* provision of Section 507, not two.

U.S. 25, 28-29 (1952); *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940).

3. The four-part *Lorber Industries* standard on which the court of appeals relied in concluding that a "penalty" is not an "excise tax" for purposes of Section 507(a)(7)(E) (see pages 6, 9, *supra*) has no proper application in this context. That test was formulated by the Ninth Circuit to determine whether an exaction that a State describes as a priority "tax" is instead a non-priority user fee. See 675 F.2d at 1066. Even if we assume that the *Lorber Industries* analysis is relevant in determining whether an exaction is a "tax" or a user fee for purposes of the general bankruptcy priority for a postpetition "tax" (11 U.S.C. 503(b)(1)(B), 507(a)(1)), it is not relevant in determining whether an exaction is a "penalty" or an "excise tax" within the specific priority established in Section 507(a)(7)(E).[11] The test described in

[11] In this case, in denying priority to the Section 4971(a) tax, the court of appeals relied (Pet. App. 5a) on its earlier decision in *United States* v. *Dumler*, 983 F.2d 161 (10th Cir. 1992). That case concerned whether the tax on premature distributions from qualified pension plans (26 U.S.C. 72(t)) was a "tax on or measured by income" for purposes of the priority established in Section 507(a)(7)(A) of the Bankruptcy Code. 983 F.2d at 163-164. The court of appeals did not attempt in this case to explain why the analysis of that decision should be applied in determining whether an exaction is an "excise tax" under the more specific provisions of Section 507(a)(7)(E) of the Code.

This Court's decisions in *City of New York* v. *Feiring*, 313 U.S. 283 (1941), and *New Jersey* v. *Anderson*, 203 U.S. 483 (1906), on which the court of appeals relied in *United States* v. *Dumler*, 983 F.2d at 163, involved whether state and local exactions constituted "taxes" for purposes of the priority for taxes under the former Bankruptcy Act (see note 8, *supra*). As the

Lorber Industries does not address whether a tax that is designed to discourage or monitor undesirable conduct is an "excise" or a "penalty."

As we have explained, however, an "excise tax" is often, if not ordinarily, designed to accomplish regulatory or deterrent objectives, as well as to raise revenue. See pages 16-17, *supra*. Moreover, Congress expressly designated the tax imposed under Section 4971 as an "excise tax." See pages 14-16, *supra*. The legislative history and the plain text of Section 507(a)(7)(E) reflect that the priority for an "excise tax" applies to all such exactions "generally considered *or* expressly treated as excises" (124 Cong. Rec. 32,416 (1978) (Rep. Edwards) (emphasis added)). The plain text, and the plain legislative command, of the Bankruptcy Code should not have been disregarded by the court of appeals. See, *e.g.*, *Patterson* v. *Shumate*, 504 U.S. 753, 757-759 (1992); *Connecticut National Bank* v. *Germain*, 503 U.S. 249, 253-254 (1992); *United States* v. *Ron Pair Enterprises, Inc.*, 489 U.S. at 242.

Sixth Circuit noted in *Mansfield Tire & Rubber Co.*, 942 F.2d at 1060, although it is appropriate carefully to review the designation of state and local exactions to insure that such claims are not improperly promoted within the federal priority scheme, courts are not free to recast an exaction that Congress has designated as a "tax" to be something else. In *A. Magnano Co.* v. *Hamilton*, 292 U.S. 40, 43 (1934), this Court stated that whether an exaction is for the public purpose of raising revenues turns on "the use which is to be made of the revenue derived from the tax, and not [on] any ulterior motive or purpose which may have influenced the legislature in passing the act." In any event, for the reasons we have explained, cases involving a general priority for "taxes" are not relevant in determining the scope of the more specific priority for "excise taxes" under Section 507(a)(7)(E).

II

IN THE ABSENCE OF INEQUITABLE CONDUCT BY THE GOVERNMENT, THE EXCISE TAX CLAIM OF THE UNITED STATES UNDER SECTION 4971(A) OF THE INTERNAL REVENUE CODE MAY NOT BE SUBORDINATED TO GENERAL UNSECURED CLAIMS UNDER THE "PRINCIPLES OF EQUITABLE SUBORDINATION" CODIFIED IN SECTION 510(C) OF THE BANKRUPTCY CODE

The court of appeals not only held that the claim of the United States under Section 4971(a) of the Internal Revenue Code should be denied the priority established for every "excise tax" under Section 507(a)(7)(E) of the Bankruptcy Code. The court further concluded that the government's claim should be "equitably" subordinated even to the general unsecured claims of all other creditors (Pet. App. 6a-8a).[12]

The court recognized (Pet. App. 7a) that, "[i]n general, equitable subordination is imposed only when a creditor has committed some kind of wrongful conduct. *In re Virtual Network Servs. Corp.*, 902 F.2d 1246, 1248 (7th Cir. 1990); *Benjamin* v. *Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977)." The court stated, however, that under the "principles of equitable subordination" codified in Section 510(c) of the Bankruptcy Code, 11 U.S.C. 510(c)(1), "a court

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[12] Because the court of appeals did not treat the excise tax claim as a claim entitled to priority under Section 507(a)(7)(E), the court expressly declined to consider whether "principles of equitable subordination" would permit the subordination of a priority claim asserted by an innocent creditor (Pet. App. 6a). That related question is the subject of *United States* v. *Noland*, No. 95-323, which is to be argued in tandem with this case. See note 2, *supra*.

may subordinate a nonpecuniary loss tax penalty claim without a showing of misconduct on the part of the government" (Pet. App. 7a). The court reasoned that "the equities in this case" favor subordinating the government's claim in order to avoid "harm [to] innocent creditors," such as "the PBGC, which will be paying the pension benefits due under [respondent's] terminated pension plan" (*id.* at 8a).

1. The expansive powers that the court has assumed under the doctrine of equitable subordination reflect a fundamental transformation and a serious misapplication of that doctrine. The judge-made doctrine of equitable subordination has a clear origin and a limited scope (*In re Columbia Ribbon Co.*, 117 F.2d 999, 1002 (3d Cir. 1941)):

> [A] court of bankruptcy under its equitable powers may disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims.

As we explain in detail in the brief filed concurrently in *United States* v. *Noland* (see note 2, *supra*), the doctrine of equitable subordination permits a court to subordinate a particular claim only if the claimant has acted inequitably in obtaining or enforcing its claim, to the detriment of other creditors. The issue that is to be resolved "under principles of equitable subordination" is whether (2 Collier Bankruptcy Manual ¶ 510.01[1], at 510-2 (3d ed. 1995)):

> harmful conduct [of the claimant] was directed at other creditors. If it was, the claim which is otherwise provable and allowable should be postponed until the claims of the creditors, who were harmed, have been satisfied.

See *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 229 (1948); *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939); A. Herzog & J. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 85 (1961).

The doctrine of equitable subordination does not, however, authorize a court to disregard categories of priorities specified by statute merely because the court concludes that a *different* ordering of priorities would yield a result that the court deems more appropriate or fair. By enacting a specific hierarchy of statutory priorities, Congress has itself measured the "equities" of the various classes of claims. *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940). Claims that Congress has placed within the same class are to be treated on identical terms. Equitable subordination does not authorize a court to "reweigh" the equities that Congress itself has already adjusted.

As this Court has held, "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988). In *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787, cert. denied, 423 U.S. 913 (1975), the Ninth Circuit explained that:

> it is important to keep in mind that the chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule. Courts of equity have long applied standards of conscience to conduct on an individual basis to prevent formally

proper but unconscionable applications of legal rules; they have not engaged in the practice of making abstract legislative judgments about the fairness of a result contemplated by the legislature's statutory scheme if it has otherwise been followed in good faith and without overreaching.

Courts therefore traditionally and consistently held that "[d]ecisions about the treatment of *categories* of claims in bankruptcy proceedings * * * are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination." *Burden* v. *United States*, 917 F.2d at 122 (Alito, J., concurring in part and dissenting in part; emphasis added). See also *Benjamin* v. *Diamond*, 563 F.2d 693, 700 (5th Cir. 1977) (equitable subordination requires that "[t]he claimant must have engaged in some type of inequitable conduct"); *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788 ("there must be conduct either in acquiring or asserting the claim which is itself inequitable in order to subordinate a claim"); *In re Credit Industrial Corp.*, 366 F.2d 402, 408 (2d Cir. 1966). As the Eighth Circuit stated in *United States* v. *Killoren*, 119 F.2d 364, 366, cert. denied, 314 U.S. 640 (1941), in reversing a decision that had applied "equitable subordination" to a claim for taxes, "[t]he plain mandate of the law cannot be set aside because of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence."

2. a. In 1978, Congress codified the judge-made doctrine of equitable subordination as Section 510(c) of the Bankruptcy Code. That provision states that bankruptcy courts may, "under principles of equitable

subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." 11 U.S.C. 510(c)(1). As we describe in detail in the brief filed concurrently in *United States* v. *Noland* (see note 2, *supra*), the text and history of this provision confirm that, in codifying the "principles of equitable subordination," Congress did not alter the established scope of that doctrine.[13] Because the "principles of equitable

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[13] The House Report on the provision enacted as Section 510(c) of the Bankruptcy Code indicates that Congress understood the doctrine of equitable subordination to be a narrow one. The Report states (i) that equitable subordination may be invoked only to deny equal treatment to creditors based on inequitable or unconscionable conduct in which they engaged or based on some special position which they occupied vis-a-vis the bankrupt that justified subordination of their claims and (ii) that the doctrine of equitable subordination is therefore inapplicable to the claims of innocent parties. H.R. Rep. No. 595, 95th Cong., 1st Sess. 196 (1977). See S. Rep. No. 989, 95th Cong., 2d Sess. 74 (1978):

> [A]ny subordination ordered under this provision must be based on principles of equitable subordination. These principles are defined by case law, and have generally indicated that a claim may normally be subordinated only if its holder is guilty of misconduct.

In addition to the decision in this case and in *United States* v. *Noland* (note 2, *supra*), other courts have recently held that the "principles of equitable subordination" codified in Section 510(c) are *not* confined to remedying creditor misconduct and instead permit courts categorically to subordinate "penalty" claims to the claims of other creditors who have incurred an "actual pecuniary loss" (Pet. App. 52a). See *Burden* v. *United States*, 917 F.2d 115, 119-120 (3d Cir. 1990); *United States* v. *Noland*, 48 F.3d 210 (6th Cir. 1995), cert. granted, No. 95-323 (Dec. 1, 1995); *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990); *Schultz Broadway Inn* v.

subordination" do not permit courts to restructure the categorical classifications of claims that Congress has made, or to subordinate *any* claim in the absence of inequitable conduct by a particular creditor, the court of appeals erred in subordinating the innocent claim of the government in this case. See Pet. App. 6a (noting that there was "no inequitable conduct on the part of the Internal Revenue Service").

b. Moreover, the court of appeals erred in this case in asserting that the lawful enforcement of "penalty" claims within the distributive classification that Congress established for such claims would effect an "inequitable" result. In reaching that conclusion, the court of appeals disregarded the decisions of this Court holding that penalties enacted by Congress are a "legitimate means to enforce" compliance with the law and must be given the priority in bankruptcy that Congress established for such claims. *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966).[14]

United States, 912 F.2d 230, 232-234 (8th Cir. 1990). In so holding, these courts misinterpreted the legislative history of Section 510(c) and erred for the reasons explained in detail in the brief that we have filed concurrently in *United States* v. *Noland* (see note 2, *supra*).

[14] In *New Jersey* v. *Anderson*, 203 U.S. 483 (1906), the Court rejected the assertion that a statutory priority for state taxes should not be recognized because it created an "injustice" for other creditors and gave the State an undue "advantage" (*id.* at 490):

> [C]onsiderations of this character, however properly addressed to the legislative branch of the government, can have no place in influencing judicial determination. It is the province of the court to enforce, not to make the laws, and if the law works inequality the redress, if any, must be had from Congress.

In evaluating the "equities" of enforcing the Section 4971 excise tax, the court of appeals also erred in narrowly focusing on the effect of the tax on a single bankruptcy estate. The court acknowledged that this excise tax is designed to promote compliance with the minimum funding requirements of qualified pension plans (Pet. App. 6a, 47a). The ability of the excise tax to accomplish the "legitimate" legislative objective of ensuring wide compliance with pension funding requirements obviously depends upon the ability of the government to enforce that tax. The priority that Congress provided for excise taxes in 11 U.S.C. 507(a)(7)(E) is designed precisely to ensure the enforceability, and therefore the effectiveness, of such taxes.

The court of appeals ignored the structural role of the Section 4971(a) excise tax in concluding that it was "inequitable" for that tax to be given priority over the claim of "the PBGC, which will be paying the pension benefits due under [respondent's] terminated pension plan" (Pet. App. 8a). Even if the excise tax priority would be adverse to the interest of the PBGC in obtaining a distribution from a *particular* bankruptcy estate, the function of the excise tax (and of the priority afforded to it) is to make it ordinarily unnecessary for the PBGC to participate in bankruptcy cases by ensuring the full and timely funding of pension plans in *advance* of bankruptcy. See, *e.g.*, Staff of Senate Comm. on Finance, 100th Cong., 1st Sess., *Omnibus Budget Reconciliation Act of 1987, et al.* 180 (Comm. Print No. 100-63) (1987) (the excise tax "for failure to make contributions [is] needed to help ensure that contributions are made when due").

By focusing instead only on what the court perceived to be "fair" or "unfair" on the facts of the pre-

sent case, the court thus neglected to consider that, in adopting categorical priorities for the distribution of bankruptcy estates, Congress has itself measured the "equities" of the various classes of claims. *Carpenter* v. *Wabash Ry.*, 309 U.S. at 28. The court of appeals improperly relied on "principles of equitable subordination" to annul and supplant the legislative determination that Congress made of the proper priority to be afforded to the government's innocent assertion of its claim.

c. At the same time that the "principles of equitable subordination" were codified as Section 510(c) of the Bankruptcy Code, Congress expressly provided for the subordination of *pre*petition nonpecuniary loss penalties *only* in cases under Chapter 7 of the Code. 11 U.S.C. 103(b), 726(a)(4).[15] The text and history of these provisions reflect an explicit congressional determination *not* to subordinate prepetition nonpecuniary loss penalty claims in cases—such as the present case—that arise under Chapter 11 of the Bankruptcy Code.[16] In enacting the Bankruptcy

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[15] The tax penalty involved in *United States* v. *Noland*, *supra*, is a *post*petition tax penalty for which Congress provided "[f]irst" priority in distribution in Chapter 7 cases. See 11 U.S.C. 503(b)(1)(B), 507(a)(1), 726(a)(1).

[16] The trustee is similarly allowed to avoid liens securing such penalties only in cases arising under Chapter 7. See 11 U.S.C. 724(a). The legislative reports emphasized the different treatment envisioned for penalties in cases under Chapter 7 and under Chapter 11:

> The lien is made voidable rather than void in chapter 7, in order to permit the lien to be revived if the case is converted to chapter 11, under which penalty liens are not voidable. To make the lien void would be to permit the filing of a chapter 7, the voiding of the lien, and the conversion to a chapter 11, simply to avoid a penalty lien, which should be valid in a reorganization case.

H.R. Rep. No. 595, *supra*, at 382; S. Rep. No. 989, *supra*, at 96.

Code, Congress considered and rejected a proposal to subordinate all "nonpecuniary loss" penalty claims under all chapters of the Code. *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406(a)(3) (1973). Instead, Congress provided for the subordination of "nonpecuniary loss" penalties only in Chapter 7 cases. See 11 U.S.C. 726(a)(4). In Chapter 11 cases, such as the present case, Congress elected to place such penalties within the class of general unsecured claims.

By concluding that a prepetition nonpecuniary loss penalty should be subordinated to the claims of general unsecured creditors in Chapter 11 cases, the decision of the court of appeals thus contradicts the statutory treatment that Congress deliberately provided for such claims. Through misapplication of the "principles of equitable subordination," the court of appeals substituted its judgment about the relative worthiness of a category of claims for the different judgment that Congress made in enacting the Bankruptcy Code. As the Ninth Circuit stated in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788, the doctrine of equitable subordination does not permit a court to say, "in effect, * * * 'No, the distribution scheme provided by the [Bankruptcy] Act is a mistake.'"

The establishment of categorical priorities among competing, innocent claimants has never been the function of the judiciary in bankruptcy cases. In the Bankruptcy Code itself, Congress has specified in

detail the priorities that particular categories of innocent claimants are to receive. By ignoring these statutory priorities—and, indeed, adopting a precisely opposite set of priorities in this case—the decision of the court of appeals represents a marked departure both from the common understanding of "equitable" authority and from the specific understanding of the doctrine of "equitable subordination" that Congress codified in 1978 as Section 510(c) of the Bankruptcy Code. The court erred in substituting its own view of an "equitable" priority scheme for the statutory scheme that Congress itself established.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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